The Large Public Power Council

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Bureau of Public Debt
Division of Special Investments
Department of the Treasury
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The Large Public Power council ("LPPC") is pleased to submit these comments to the Bureau of Public Debt ("BPD") concerning the recently issued proposed regulations (the "Proposed Regulations") relating the rules governing Treasury's State and local government securities program ("SLGS"). The LPPC is an association of 24 of the largest governmentally owned electric utilities in the United States. Our members include not only the largest governmentally owned retail electric systems in the county but also a number of wholesale sellers of electricity that themselves serve municipally owned retail systems. It is estimated that our members serve approximately 18 million retail customers and own and operate over 11.61 billion megawatt hours of generation. In addition, the members of the LPPC own and operate approximately 26,000 circuit miles of transmission lines. Further, our members have approximately $50 billion of tax-exempt bonds outstanding and are regular users of the SLGS program. Our members are located throughout the country, including California, Arizona, New York, Texas, Washington, Florida, Georgia, Nebraska, Tennessee, South Carolina, and Colorado.

SUMMARY

LPPC's members are regular and significant users of the SLGS program and believe it to be a critical part of structuring refunding transactions. LPPC understands the BPD's concerns with the administrative burden of operating the SLGS program, perceived abuses of the SLGS program, and its need to address those issues. However, we believe that the Proposed Regulations involve a significant overreaction to the BPD's concerns, unnecessarily impose multiple restrictions to deal with each concern, and would undo relatively recent changes to the SLGS program that were adopted to make the program more attractive. LPPC recommends that:

- the SLGS regulations continue to permit penalty free cancellation of subscriptions;
- in lieu of a requirement that issuers authorize their bonds prior to subscribing, issuers should be required to certify their intent to issue the bonds;

- the SLGS regulations should continue to permit the delivery date for SLGS to be changed by up to 7 days;

- the SLGS regulations should continue to permit the investment of funds other than gross proceeds of tax-exempt bonds if the investment would assist the issuer in complying with the arbitrage rules;

- the period during which SLGS can be purchased should be extended beyond 6 p.m. eastern standard time; and

- the proposal to limit the purchase and redemption of SLGS so that issuers cannot increase the yield on their investments should be eliminated.

As a general matter, LPPC believes that the combination of the required use of SLGSafe, setting interest rates at 10:00 a.m. each day, and an issuer certification that it intends to purchase the SLGS to which the subscription relates will adequately address the BPD's concerns. LPPC also believes that it is critical that, in finalizing the SLGS regulations, the Treasury Office of Tax Policy must be involved. The reason for the existence of the SLGS program has always been to assist issuers in complying with the tax law rules for arbitrage bonds and, therefore, Tax Policy should be involved in these efforts. Set forth below is a discussion of LPPC's general concerns with the Proposed Regulations followed by more detailed comments.

DISCUSSION

General. In 1996, the BPD significantly modified the SLGS regulations to make the program more flexible and to provide incentives to issuers of tax-exempt bonds to invest in SLGS rather than "open market" securities. In connection with the issuance of those regulations, the BPD stated:

> The Department of the Treasury, Bureau of the Public Debt, desires to make the SLGS securities program more attractive and flexible for State and local government issuers of debt obligations that are subject to the arbitrage and rebate rules of the Internal Revenue Code.

Thus, issuers were given the ability to subscribe for SLGS and cancel those subscriptions without penalty. Similarly, issuers were permitted to cancel a SLGS subscription without penalty and resubscribe for SLGS at higher rates. Further, issuers were permitted to redeem SLGS and reinvest in new SLGS at higher rates, again without penalty. At the time that these changes were put in place, the Treasury recognized the obvious "option" value implicit in many of these provisions and that this value is not available to purchasers of other types of Treasury securities. Despite this, the final 1996 regulations put these provisions into effect and, as indicated above, the preamble to those regulations made clear that the Treasury was trying to provide greater flexibility and make the program more attractive. We believe that the purpose of these provisions was to provide substantial economic incentives to encourage issuers to invest in SLGS rather than open market securities. The 1996 regulations were the

product of a collaborative effort between the Treasury Department and the public finance community.[1] The 1996 changes were a response to concerns expressed by market participants that the program was too cumbersome and led issuers to invest bond proceeds in open-market securities. The 1996 changes to the SLGS program were of such significance and so clearly designed to benefit issuers of tax-exempt bonds that the changes were announced by the Secretary of the Treasury, who stated that the changes would "make the securities a more enticing and flexible investment tool for state and local bond issuers" and "are designed to make SLGS more attractive, competitive, cost-effective securities."[2] In making these changes, Treasury stressed the elimination of extensive certifications and shortening notice periods.[3] At the time that these regulations were finalized, the IRS and Treasury and the municipal finance industry were embroiled in the yield burning controversy. The 1996 changes to the SLGS regulations were clearly designed to move issuers away from the use of open market securities and into greater use of SLGS. At that time, Treasury determined that the problems and potential abuses involved with the purchase of open market securities were so serious that issuers should be provided with financial incentives to invest in SLGS, even if those financial incentives reduce the financial benefit of the SLGS program to the Treasury. Thus, these changes were motivated as much by the desire to ease IRS enforcement as to benefit issuers of tax-exempt bonds.

Treasury may also have taken into account in making this determination that the SLGS program as a whole produces savings to the Treasury through the lower borrowing cost of that program. After all, no other investors are lending Treasury money at zero percent or at rates comparable to the rates offered under the demand deposit program. In addition, the interest rates on time deposit SLGS are 5 basis points below the rates on other Treasury securities and the SLGS program effectively permits the Treasury to obtain the benefit of borrowing at tax-exempt rates. If the Proposed Regulations are adopted and, as we expect, issuers are effectively compelled to make greater use of open markets, Treasury's additional borrowing costs are likely to far exceed the savings from the reduced administrative burden to BPD, particularly since these administrative burdens can be addressed through much less drastic changes. Further, with respect to the ability to cancel a subscription and resubscribe at higher rates, Treasury may have determined that State and local governments should be afforded the equivalent of most favored customer status and should be permitted to invest at the same rates being offered others, even if a State and local government had agreed to purchase at lower rates. None of this has changed in the years since 1996. In addition, the Proposed Regulations would impose a host of new certifications and reverse the flexibility provided in 1996.

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1 "I think it's a perfect example of consultative rulemaking, where we were brought into the process, consulted, asked to help find the solution, and I think its a win-win situation," said Catherine Spain, director of the Government Finance Officers Association. Bond Buyer, Inc., October 23, 1996, Pg. 4, New SLGS Rules Make for a More Viable Option, Players Say, By Joanne Morrison.

2 Ibid.

3 Ibid.

It is inconceivable that the problems associated with yield burning have been so forgotten that Treasury is ready to eliminate the incentives in the existing regulations for issuers to invest in SLGS. The changes contained in the Proposed Regulations, if adopted, will inevitably lead to greater investments in open market securities and guaranteed investment contracts, the very situation that the Treasury was trying to avoid when it promulgated the 1996 SLGS regulations. Yield burning was a significant problem that, directly and indirectly, cost State and local governments and the United States enormous sums of money. The 1996 changes to the SLGS regulations should be left in place to the greatest extent possible.

Issuers should retain the ability to cancel SLGS subscriptions without penalty. The ability to cancel SLGS subscriptions without penalty and resubscribe at higher rates was the most significant incentive provided to issuers as part of the 1996 changes to the SLGS regulations. As indicated above, the "free" option provided to investors in the SLGS program was known at the time and accepted by Treasury. We strongly object to the elimination of the ability to cancel a subscription without penalty. We also disagree with the statement in the preamble to the Proposed Regulations that "the flexibility and efficiency associated with an issuer's ability to select maturities and interest payment dates, make SLGS securities a competitive investment vehicle, even without the cancellation option." It seems very clear that the elimination of the cancellation option, particularly when coupled with the other changes in the Proposed Regulations and the fact that SLGS rates are 5 basis points below the rates on other Treasury securities, will result in a significant reduction in the use of SLGS.

The preamble cites several areas of concern resulting from the ability to freely cancel SLGS subscriptions. One concern is that cancellations have occurred where agents have subscribed for SLGS even though the issuer had not authorized the issuance of the bonds. Although, as described below, we have concerns with using bond authorization as a precondition to filing a subscription, we do agree that the filing of subscriptions for transactions that are not "real" raises a concern that should be addressed. Similarly, we agree that issuers should not be permitted to avoid the 10 percent limit on modifications of the principal amount of SLGS through the filing of multiple smaller subscriptions and the cancellation of the excess. We also appreciate the difficulties that can result from cancellations for Treasury in cash balance forecasting, although we believe that this concern can be addressed without eliminating the ability to cancel a subscription without penalty (e.g., by increasing the notice required for cancellations).

As indicated above, clearly the cost-free option was recognized when the 1996 regulations were adopted. Related to this, Treasury also recognized that it was providing investors with the ability to obtain the highest SLGS rates available during the period between the filing of a subscription and the delivery of the related SLGS. The preamble to the Proposed Regulations does not indicate why this ability to obtain the highest rates is being eliminated. This will cost issuers of tax-exempt bonds enormous sums of money and we strenuously object to this change. On the other hand, we recognize that Treasury may not have realized that issuers and their advisors would use the ability to cancel subscriptions for SLGS without penalty to lock in interest rates during a 60-day period with respect to a refunding transaction that is highly speculative and dependent on interest rates falling after the filing of the subscription. However,

we believe that this concern can be addressed while preserving the ability to cancel a subscription without penalty. For example, the requirement of a certification limiting subscriptions to "real" transactions rather than those that are speculative should adequately address BPD's concerns. Thus, issuers could be required to certify that, based on SLGS rates and tax-exempt interest rates on the date that the subscription is filed, the issuer reasonably expects to proceed with its refunding transaction. Alternatively, the submission of a subscription for SLGS could be conditioned on the issuer having mailed a preliminary official statement for the related bonds. There is nothing abusive in State and local governments obtaining the highest rates available in the case of "real" transactions.

Requirement that bonds be authorized in order to purchase SLGS. The Proposed Regulations would require that, in order to subscribe for SLGS, an issuer must have authorized the related bonds. Although the Proposed Regulations do not define what is meant by "authorizing" the Bonds, if this term is given its plain meaning, it will create substantial problems for issuers subscribing for SLGS. Bonds are ordinarily not authorized until fairly late in the financing process. SLGS are normally subscribed for a day or two before the issuer executes a contract to sell its bonds. Prior to the "sale date," there may be no formal authorization for the issuance of the bonds. Issuers ordinarily need to subscribe for SLGS on the day that they price their bonds: that is the day that the bond issue is sized and the escrow structured. If issuers have to wait until after the pricing date, it will be impossible to know whether a SLGS escrow can be purchased with the available bond proceeds. As a result, a requirement that the issuance of the bonds be authorized before subscribing for SLGS would make it impossible for most issuers to subscribe for SLGS on the pricing date and would compel issuers to use other investments for their escrows.

The LPPC understands that the BPD believes that the current SLGS subscription program has made it difficult for it to manage its overall borrowing and cash flow requirements and that it desires to obtain a greater degree of certainty regarding the amount and timing of the issuance of SLGS. Further, we understand that BPD is concerned that some have used the current flexibility in the SLGS program to subscribe for SLGS in circumstances in which there is not necessarily a bond transaction that is ready to come to market. The LPPC believes that these concerns can be addressed through other means rather than a requirement that the bonds be authorized before submitting a subscription, such as the type of certification described above.

We also note that the requirement that the bonds be authorized before a SLGS subscription is filed is duplicative of the other restrictions contained in the Proposed Regulations. For example, if the ability to cancel a subscription without penalty is retained, there is no need to also require bond authorization as a condition to filing a subscription.

Ability to modify SLGS delivery date. The Proposed Regulations would eliminate the ability to change the delivery date of SLGS by up to 7 days. We assume that this change is motivated by the BPD's need to better manage it's cash flow. However, this change, like many others contained in the Proposed Regulations, would reduce the flexibility currently provided by the SLGS program and can be addressed through other means. For example, issuers could generally be required to provide greater notice to BPD of changes to the delivery date of SLGS.

The LPPC also does not believe that the ability to change the delivery date for SLGS by up to 7 days contributes in any substantial way to issuers using SLGS as a free option. Moreover, the reason an issuer may change the delivery date of SLGS is because of changes to the issue date of the issuer's bonds that are outside of its control. In an extreme example, we understand that issue dates of certain Florida bonds had to be changed due to the multiple hurricanes experienced in that State. In these circumstances, it seems unnecessarily burdensome and impractical to require issuers dealing with these circumstances to also have to seek BPD's permission to change the delivery date of its SLGS.

Issuers should be permitted to increase yield in the purchase and redemption of SLGS. The Proposed Regulations would require that issuers certify that, in purchasing or redeeming SLGS, the new investment of the related amounts will not be invested at a higher yield than those amounts had been invested. The preamble to the Proposed Regulations indicates that this change, along with several others, would be imposed to prevent issuers from making an arbitrage-like profit derived from the infrequent pricing of SLGS. Given the other changes contained in the Proposed Regulations, we believe that these new certifications are unnecessary and will inappropriately penalize issuers. First, establishing SLGS rates each morning based on then-current interest rates will eliminate much of the ability of issuers to profit through the simultaneous purchase of SLGS and sale of other securities (or vice versa): much of this profit has stemmed from the fact that SLGS rates have been based on interest rates from the previous day. Second, limiting the hours in which SLGS can be purchased will further reduce the ability to "arbitrage" SLGS rates. Under the current rules, SLGS rates effectively stay in effect for 32 hours and the Proposed Regulations would significantly reduce this window. It may even be possible to further limit the hours that redemption notices can be submitted and SLGS subscribed for with respect to escrow restructurings. The Proposed Regulations would also prevent issuers from maximizing their investment returns in transactions in which they could profit independent of "stale" SLGS prices. Issuers might increase yield by moving from SLGS to higher-yielding securities or by purchasing securities with longer maturities. For example, an issuer who has invested bond proceeds on deposit in its debt service reserve fund in 2-year SLGS might determine to redeem that investment and reinvest in 5-year SLGS. This transaction would be accomplished for reasons having nothing to do with SLGS pricing, and illustrates that the Proposed Regulations significantly impact transactions that raise none of the concerns that prompted the changes being proposed.

Setting of SLGS rates. The LPPC believes that setting SLGS rates each morning based on that day's rates, as the BPD implied in the preamble to the Proposed Regulations, and posting those rates at 10 a.m. would reduce many of the problems associated with the mismatch between SLGS rates and market rates and the related "arbitrage" opportunities. The LPPC does not, however, believe that SLGS should be required to be purchased by 6 p.m., particularly in the case of purchases of SLGS in connection with the issuance of refunding bonds. This change would create difficulties in pricing refunding transactions, especially for issuers in the western part of the United States. In addition, it is commonly the case that the refunding transaction and escrow will not have been fully verified by the independent accountants engaged for that purpose by 6 p.m. Typically, issuers prefer not to subscribe for SLGS prior to the transaction being verified, since the sizing of the bonds and escrow could change. As a result, the new 6 p.m.

deadline would be a problem for many issuers and the ability to modify the subscription by 10 percent will not always be sufficient to cure this problem. Moreover, since market rates do not change after 6 P.M., there seems no risk of rate volatility to necessitate a 6 P.M. subscription limitation.

Permit the investment of funds other than gross proceeds of tax-exempt bonds. Under the current regulations, amounts other than gross proceeds of tax-exempt bonds may be invested in SLGS if the investment would assist the issuer in complying with the arbitrage rules. This rule would be eliminated under the Proposed Regulations but should be retained. There is no good reason to restrict the use of the SLGS program. The rule that would be eliminated under the Proposed Regulations has often been used by issuers of tax-exempt bonds to ensure compliance with the fair market value limitations contained in the arbitrage rules, particularly with respect to funds that are not initially subject to the arbitrage rules but will become restricted in the future, or with respect to funds that are initially gross proceeds of an issue, but will lose that characterization in the future. This could happen, for example, where taxable bonds are issued to refund tax-exempt bonds where the tax-exempt bond proceeds will become transferred proceeds (as defined in section 1.148-1 of the Income Tax Regulations) of the taxable bonds (and no longer be gross proceeds of the tax-exempt bonds), and vice versa. In addition, this could happen where the universal cap (as defined in section 1.148-6(b)(2) of the Income Tax Regulations) causes proceeds of tax-exempt or taxable bonds to be deallocated from the bonds and reallocated to taxable or tax-exempt bonds, respectively. SLGS have also been used as investments in commingled funds (as defined in section 1.148-1 of the Income Tax Regulations), which include both gross proceeds and other amounts. This is because section 1.148-6(e) of the Income Tax Regulations treats bond proceeds as invested in a pro rata portion of all of the investments in the commingled fund, and SLGS ensure that all of the investments are purchased at fair market value. Accordingly, the current rule should not be changed.

Use of SLGSafe. The LPPC does not object to the mandated use of the SLGSafe program if such use will reduce the BPD's administrative burdens. Since many issuers do not currently use SLGS-Safe, we suggest providing an extended period of time of not less than 180 days during which issuers could continue to subscribe under the current rules to ensure that there is plenty of time for issuers to learn to process SLGS applications via SLGSafe applications. We also believe that a back-up mechanism for subscribing for SLGS is needed for situations where issuers or the BPD are encountering internet access difficulties (e.g., due to viruses).

Regulatory process. Prior to issuing the Proposed Regulations, BPD and Treasury staff sought the input of issuers and other market participants. The LPPC viewed this as a positive step that, we hoped, would lead to proposals that were responsive to the industry's concerns. We were, however, disappointed when the Proposed Regulations were issued that so few of the industry's concerns seemed to be taken into account. Equally troubling is the extremely short comment period provided with respect to the Proposed Regulations (even with a 15 day extension) and Treasury's determination that these proposals are not a "significant regulatory action," and the resulting lack of a public hearing and other regulatory safeguards. Given the size of the SLGS market, the significance of the changes proposed, and the resulting cost to State and local governments, there can be no doubt that the Proposed Regulations are a significant

regulation. The fact that the Proposed Regulations apply exclusively to units of State and local government further suggests the need for a careful regulatory approach.

Closing of SLGS window. We understand that Treasury does not have the ability to prevent the closing of the SLGS window where the debt ceiling is reached. On the other hand, we believe that steps can and must be taken to provide advance notice of the closing of the SLGS window. The most recent closing of the window seemed to be preceded by less than one hour's notice on the website. The resulting uncertainty caused by this lack of notice should be avoided.

Conclusion. The LPPC appreciates the concerns raised by the BPD with respect to the SLGS program, particularly the administrative burdens and cash management issues resulting from the current system. However, we believe that the flexibility contained in the current regulations was established intentionally to make the program more attractive to issuers of state and local bonds and to encourage those issuers to maximize the use of the SLGS program. The reasons behind the adoption of those provisions of the current regulations have not changed. We also believe that, due to the 5 basis point reduction in rates on SLGS as compared to the rates on other Treasury securities, the SLGS program results in a substantial savings to the Treasury of more than $70 million according to one estimate. As a result, changes to the SLGS program that would reduce its flexibility and lead to greater use of open market securities should be minimized to the greatest extent possible. We believe that BPD's concerns can be adequately addressed, without significant harm to issuers of tax-exempt bonds, through a combination of the mandated use of SLGSafe, the setting of SLGS rates each morning prior to 10 a.m., and a requirement that issuers certify their expectation to purchase the SLGS for which the subscription is submitted. At a minimum, the BPD should first implement these changes and assess their success before making the types of dramatic changes contained in the Proposed Regulations.

Sincerely,

Noreen Roche-Carter, Chair
Large Public Power Council
Tax and Finance Task Force

cc: Gregory F. Jenner
Acting Assistant Secretary (Tax Policy)